No. 06-484

In the Supreme Court of the United States

TELLABS, INC., et al.,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., et al.,

Respondents.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

BRIEF FOR OHIO AND 23 OTHER STATES, TERRITORIES AND COMMONWEALTHS AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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TABLE OF CONTENTS

Page

TABLE OF CONTENTS i

TABLE OF AUTHORITIES iii

INTRODUCTION 1

INTEREST OF THE AMICI STATES 2

SUMMARY OF THE ARGUMENT 2

ARGUMENT 4

A. The pleading standard advanced by Tellabs thwarts the carefully balanced purposes of the PSLRA—curbing frivolous complaints, but also encouraging meritorious claims—and effectively precludes the States' large investment funds from aggressively monitoring the market. 4

1. PSLRA was passed to curb frivolous complaints, but also to encourage meritorious claims. 4

2. The pleading standard advanced by Tellabs would severely damage one of the most powerful mechanisms for controlling fraud in the marketplace: legitimate securities lawsuits by large institutional investors such as the States' pension funds 6

a. "Strike suits" are bad for business, but fraud is worse 6

b. Under the Seventh Circuit's pleading standard, institutional investors, such as the States' pension funds, have balanced incentives: strong economic incentives to litigate meritorious claims and equally strong economic disincentives to pursue "strike suits." 7

B. The Court should reject Tellabs's pleading standard because Congress intended the SEC to protect private investors after having stripped them of some State remedies in this area. 10

1. In response to rampant fraud in the securities industry, the States were first to protect citizen investors by passing "blue-sky" laws. 11

2. The federal government first regulated the securities industry only in the 1930s. 13

3. The Court should preserve the balance created by Congress in the PSLRA and protect the interests of investing consumers. 14

CONCLUSION 17

TABLE OF AUTHORITIES

Cases **Page(s)**

ABC Arbitrage Plaintiffs Group v. Tchuruk,
291 F.3d 336 (5th Cir. 2002) 5

Adams v. Kinder-Morgan, Inc.,
340 F.3d 1083 (10th Cir. 2003) 6

In re American International Group, Inc. Sec. Litig.,
Case No. 04-8141, filed Oct. 15, 2004 (S.D.N.Y.) 8

CTS Corp. v. Dynamics Corp. of Am.
481 U.S. 69 (1987) 13

City of Monroe Employees Retirement System v. Bridgestone Corp., 399 F.3d 651 (6th Cir. 2005) 5

In re Exxon Mobil Sec. Litig., Case No. 04-1257,
filed Mar. 17, 2004 (D.N.J.) 8

Fla. State Board of Admin. v. Green Tree Fin. Corp.,
270 F.3d 645 (8th Cir. 2001) 6

In re Global Crossing Ltd. Sec. Litig., Case No. 02
Civ 910, filed Jan. 28, 2003 (S.D.N.Y.) 8

Makor Issues & Rights, Ltd. v. Tellabs Inc.,
437 F.3d 588 (7th Cir. 2006) 5

In re Marsh & McLennan Cos., Inc. Sec. Litig.,
MDL 1744, Case No. 1:04-cv-8144, filed Oct. 15,
2004 (S.D.N.Y.) 9

Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Dabit,
547 U.S. 71; 126 S.Ct. 1503 (2006) 3

Novak v. Kansas,
216 F.3d 300 (2d Cir. 2000) 15

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Ohio Public Employees Ret. Sys. v. Fannie Mae, Case No. 2:04cv1106, filed Nov. 22, 2004 (S.D. Ohio) 8

In re Pilgrim Baxter Sec. Litig., (part of *In re Mutual Funds Investment Litig.*, MDL 1586), Case No. 04-md-01151, filed May 3, 2004 (D. Md.) 9

Pirraglia v. Novell,
339 F.3d 1182 (10th Cir. 2003) 6

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253 F.3d 423 (9th Cir. 2001) 6

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In re UnitedHealth Group, Inc. Shareholder Deriv. Litig., Case No. 0:06-cv-1216, filed Mar. 29, 2006 (D. Minn.) 9

Statutes and Rules

15 U.S.C. § 78a *et seq* 13

15 U.S.C. § 78bb(a) 13

15 U.S.C. § 78bb(f) 14

15 U.S.C. §78bb(f)(B) 3

15 U.S.C. § 78u-4 13

Private Securities Litigation Reform Act of 1995 ("PSLRA") ..... *passim*

Security Act of 1933 3

Securities Exchange Act of 1934 ..... 3, 13

Securities Litigation Uniform Standards Act ("SLUSA") ..... *passim*

Civil Rule 12(b)(6) 5

Briefs

Bryant v. Avado Brands, Inc., No. 98-9253, 1999 WL 33631523 (11th Cir. Feb. 16, 1999) 15

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Greebel v. FTP Software, Inc., No. 98-2194, 1999 WL 33911562 (1st Cir. May 1999) 15

Helwig v. Vencor, Inc., No. 99-5153, 2000 WL. 34432856 (6th Cir. Aug. 18, 2000) 15

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Weld v. Stage Stores, Inc., No. 00-20230, 2000 WL 34032458 (5th Cir. June 2000) 15

Zeid v. Kimberley, No. 97-16070, 1997 WL 33555504 (9th Cir. Oct. 1997) 15

Books

1-1 *Ohio Securities Law & Practice* § 1.02 (2005) 12

Harold S. Bloomenthal, 2 *Securities Law Handbook* § 25.3 (2007) 13

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Gilbert E. Brach, *The Blue-Sky Law*, 3 Marq. L. Rev. 142 (1918-1919) 12

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Hillary A. Sale, *Judging Heuristics*, 35 U.C. Davis L. Rev. 903 (2002)..... 6

Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. Corp. L. 1, (1983) 10, 11

Lynn Stout, *Symposium: Securities Litigation: The Fundamental Issues*, 38 Ariz. L. Rev. 711 (1996) 7

Julie Ann Sullivan, *The Science of Scienter: The Private Securities Litigation Reform Act's Effect and the Long-Awaited Decision of* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 1 Seventh Circuit Review 327 (2006) 4

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Other

Carrie Johnson, *13 Charged In Big Insider Trading Scam: Plots Touch 4 Elite Wall Street Firms*, Washington Post, March 2, 2007 16

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INTRODUCTION

Petitioners, Tellabs, Inc., et al. ("Tellabs"), advances an unreasonably high pleading standard for scienter that results in unbalancing the scales of justice in securities litigation. The unreasonably high standard carries the high price of blocking many meritorious claims of securities fraud that protect the market, well-run businesses, and investors.

Tellabs justifies the high pleading standard because of its stated fear of "strike suits," which, in its view, prompt otherwise profit-maximizing corporations to settle "even meritless claims for substantial sums." *Id.* at 16. See Tellabs Brief at 2, 16, 24, 27, 41 (referring to "strike suits" as Congress' overriding concern in changing securities fraud pleading requirements) and at 16 (asserting, without citation, that corporate defendants have "too often" been "forced" to settle those suits for "substantial sums").[1] As a result, Tellabs supports an unacceptable reading of the Private Securities Litigation Reform Act of 1995 ("PSLRA") that would empower judges—not juries—to assess the plausibility of every allegation of scienter and studiously ignore every allegation of "ambiguous conduct." *Id.* at 37, 41.

But Tellabs forgets the other pan on the scales—protecting investors, business, and the market from fraud. Whatever else may be said about their proposed standard, this much is certain: if it is accepted, meritorious complaints will be dismissed along with frivolous ones; fraud on the market will increase; and state pension funds, state employees, and state taxpayers will suffer.

The amici States urge the Court to adopt the balanced approach intended by Congress and used by the Seventh Circuit—a standard for pleading scienter higher than that for ordinary fraud, but not so high that even complaints based on reasonable inferences are dismissed without discovery.

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[1] Tellabs does not, however, contend that this suit is a "strike suit."

INTEREST OF THE AMICI STATES

Long before the SEC existed, the States provided their citizens with the earliest protection from securities fraud through the so-called "blue-sky" laws. Though state securities laws affording private civil remedies are now partly preempted, the States retain an interest in protecting their citizens from securities fraud. In this case the amici States see the potential for an unacceptable erosion of the rights of investors. In the absence of that protection, the amici States have a heightened interest in protecting their citizens from the unscrupulous actions of fraudulent corporations and the erosion of investors' rights in the marketplace.

Moreover, many of the amici States' pension funds are valued institutional investors in the marketplace. Amici States have a direct stake in protecting the rights of these important institutional investors—as well as the retirement funds of their public employees—to pursue fraud in the marketplace through securities litigation. Tellabs's proposed pleading standard would discourage pension funds and other large public shareholders from pursuing meritorious claims and curtail the important market-oversight role they play.

SUMMARY OF ARGUMENT

Tellabs's proposed, unreasonably high standard for scienter in securities fraud suits will indiscriminately turn away both frivolous and meritorious claims. Adoption of this high standard will upset the PSLRA's carefully balanced standard. Institutional investors rarely, if ever, file frivolous lawsuits, and indeed the market and investors depend on institutional investors to keep the market honest by aggressively ensuring corporate accountability. Since the PSLRA was passed in 1995, large private institutional investors have filed far fewer lawsuits, leaving the large public institutional investors—primarily the state pension funds—to file the majority of securities lawsuits on behalf of

state employees' pensions. Tellabs's proposed heightened pleading standard will discourage, and in some cases prevent, the large public investors from filing non-frivolous securities lawsuits. Not only will this prevent State funds from protecting the pensions of State employees, but these large investors will no longer be performing their market-protection role.[2]

Maintaining that balance is even more important now that the States' role in the securities registration process has been restricted. Because of widespread fraud, the States were the first entities to pass "blue-sky" laws to protect citizens from fraudulent securities sales. After the stock market crash of 1929, the federal government took over the role of protecting investors by creating the SEC and passing the Securities Act of 1933 and the Securities Exchange Act of 1934. Traditionally, the federal authorities focused primarily on the national markets, while the States monitored local markets.

But in the 1990s, a rapid increase in the filing of securities-fraud complaints—many of which were perceived as nothing more than frivolous strike suits—led the federal government to enact the PSLRA in 1995 and the Securities Litigation Uniform Standards Act ("SLUSA") in 1998. The SLUSA preempted most private civil applications of the states' blue-sky laws,[3] and the PSLRA established the pleading standard for scienter at issue here. If the Court

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[2] The *amici* States recognize that state blue-sky laws are not preempted as to the state pension funds. 15 U.S.C. §78bb(f)(B). However, the majority of securities fraud claims are tried as large, multi-state cases, essentially requiring venue and jurisdiction in federal court.

[3] The preemptive effect of SLUSA is limited to class-action civil lawsuits by private investors. Individual civil actions and state agency enforcement of blue-sky laws remain viable under SLUSA. See, *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71; 126 S.Ct. 1503 at 1514 (2006). However, because many, if not most, civil securities actions are brought as class actions, SLUSA effectively prevents most private lawsuits originally brought under the state blue-sky laws.

adopts Tellabs' unreasonably high standard for scienter, the combination of these two laws will severely hamper the ability of individual and private institutional investors to protect themselves from fraudulent securities sales.

Many States and their citizens are still reeling from the effects of major corporate scandals, such as MCI WorldCom and Enron. Richard A. Oppel Jr., *Enron Traders on Grandma Millie and Making Out Like Bandits*, N.Y. Times, June 13, 2004 at D7. Meanwhile, private investors have been stripped of their ability to file civil class-action suits under state laws. If on the one hand Congress preempted the States from protecting their citizens by allowing private class-action suits, on the other hand Congress surely did not intend a standard for pleading scienter that left investors without any remedy. The Court must restore the balance by adopting the Seventh Circuit's evenhanded standard for pleading scienter.

ARGUMENT

A. The pleading standard advanced by Tellabs thwarts the carefully balanced purposes of the PSLRA—curbing frivolous complaints, but also encouraging meritorious claims—and effectively precludes the States' large investment funds from aggressively monitoring the market.

1. PSLRA was passed to curb frivolous complaints, but also to encourage meritorious claims.

The PSLRA was enacted not only to curb frivolous securities fraud complaints, but also to encourage meritorious ones. Julie Ann Sullivan, *The Science of Scienter: The Private Securities Litigation Reform Act's Effect and the Long-Awaited Decision of* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 1 Seventh Circuit Review 327 (2006) (PSLRA designed to curb frivolous litigation while retaining and increasing the value of meritorious claims); accord Jeffrey A. Berens, *Pleading Scienter Under the Private Securities*

Litigation Reform Act of 1995, Colo. Law., Feb. 2002, at 39, 40. Adopting the elevated scienter standard advanced by Tellabs would upset the balance by discouraging meritorious claims as well.

Tellabs seeks just that imbalance—they assert that a securities fraud complaint should be dismissed even when a *reasonable* person would infer that the defendants acted with scienter. Tellabs Brief, p. 37-41. But as the circuits have recognized, reasonable complaints are supposedly not targeted by the PSLRA and Civil Rule 12(b)(6). *Makor Issues & Rights v. Tellabs*, 437 F.3d 588, 601-02 (7th Cir. 2006); *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 354 (5th Cir. 2002); *Ronconi v. Larkin*, 253 F.3d 423, 428 (9th Cir. 2001). Rather, the circuits understand that the entire "welfare of victimized investors and the integrity of the stock market" necessarily depend on reasonable inferences getting to a jury. *Ronconi*, 253 F.3d at 428.

Moreover, Tellabs's standard would also upset the constitutional balance by asking the federal courts to rule on disputed questions of material fact at the pleading stage, thus raising a potential Seventh Amendment problem. See *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683 n.25 (6th Cir. 2005) (recognizing the "Seventh Amendment problem" posed by its own "most plausible" inference standard); *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 437 F.3d 588, 602 (7th Cir. 2006) (rejecting Sixth Circuit's "most plausible" standard in favor of "an approach that cannot be misunderstood an a usurpation of the jury's

role.").[4]

2. The pleading standard advanced by Tellabs would severely damage one of the most powerful mechanisms for controlling fraud in the marketplace: legitimate securities lawsuits by large institutional investors such as the States' pension funds.

The legal standard proposed by Tellabs addresses only one side of the securities fraud balance—how to quickly dispose of the truly frivolous suit. But by requiring judges to quantify the "strength" of "inferences" based on nothing more than a complaint, those standards neglect the opposite side of the scale—how to ensure that legitimate suits are decided on their merits. A fraudulent marketplace favors bad companies and harms both business and investors. And legitimate suits are one of the strongest mechanisms for preventing fraud in the marketplace.

a. "Strike suits" are bad for business, but fraud is worse.

No one favors frivolous lawsuits, but securities fraud is increasing and extremely damaging to the marketplace. See Hillary A. Sale, *Judging Heuristics*, 35 U.C. Davis L. Rev. 903, 958 (2002). As one scholar put it, "fraud is very, very bad for securities markets" because it erodes investor confidence:

> [F]raud is bad for securities markets because it erodes investor confidence. [F]raud makes it difficult for

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[4] See also *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1101 (10th Cir. 2003) ("The PSLRA did not, however, purport to move up the trial to the pleading stage."); *Pirraglia v. Novell*, 339 F.3d 1182, 1188 (10th cir. 2003) ("[I]t is inappropriate for us to make a determination as to which inference will ultimately prevail, lest we invade the traditional role of the factfinder."); *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 666 (8th Cir. 2001) ("The strong inference pleading standard does not license us to resolve disputed facts at this stage of the case.").

> investors to detect differences in the quality of the securities they buy. Companies issuing bad securities—poorly run firms that throw away money and do a poor job for their investors—can sell their securities at about the same price as well-managed firms, because fraud makes it impossible for investors to easily distinguish between high-quality and low-quality firms.

Lynn Stout, *Symposium: Securities Litigation: The Fundamental Issues*, 38 Ariz. L. Rev. 711, 713 (1996). Thus, bad companies flourish in a fraudulent market, and good companies flounder:

> What happens in such a market? Very quickly the market gets flooded with bad firms, because fraud allows them to sell worthless securities at high prices. Until, of course, investors learn that they can't distinguish between good and bad companies [and] begin to discount the quality of all the securities in the market. In other words, they lose confidence in the market, and will no longer pay high prices even to good firms selling quality securities. [G]ood firms exit the market, because they can't get a decent price for their securities.

Id. Frivolous suits may raise the cost of doing business, but the courts are well designed to dispose of such cases. On the other hand, rampant undetected fraud destroys the whole market. Tellabs's high scienter standard threatens all investors and all business because it discourages legitimate lawsuits and thus leaves the market open to even more fraud.

b. Under the Seventh Circuit's pleading standard, institutional investors, such as the States' pension funds, have balanced incentives: strong economic incentives to litigate meritorious claims and equally strong economic disincentives to pursue "strike suits."

The PSLRA is designed to favor institutional investors and protects public companies from strike suits. In fact, the market operates on the presumption that the investor with the "largest financial interest" at stake will be the most suitable lead plaintiff, precisely because large investors are likely both to "faithfully and diligently represent" the class of stockholders and to effectively "monitor" their counsel. Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2095, 2099 (1995).[5] Institutional funds rarely file suits deemed "frivolous." But, because of their size, they "almost always" file suits when they sustain large losses that are attributable to fraud. *Id.* at 2091.

Moreover, in the eleven years since the PSLRA's enactment, public institutional investors have served as lead plaintiffs in securities class actions considerably more often than "private institutional investors, such as mutual funds, banks and insurance companies." Stephen J. Choi & Robert B. Thompson, *Symposium: Litigation Reform Since the PSLRA: A Ten-Year Retrospective*, 106 Colum. L. Rev. 1489, 1504 (2006). For example, currently, at least six of Ohio's public pension funds are serving as lead plaintiff or co-lead plaintiff in large, private securities class actions pending in federal court. *In re Exxon Mobil Sec. Litig.*, Case No. 04-1257, filed Mar. 17, 2004 (D.N.J.) (lead plaintiffs are Ohio Public Employees Retirement System ("OPERS") and State Teachers Retirement System of Ohio ("STRS Ohio")); *Ohio Public Employees Ret. Sys. v. Fannie Mae*, Case No. 2:04cv1106, filed Nov. 22, 2004 (S.D. Ohio) (lead plaintiffs are OPERS, STRS Ohio, and Ohio Bureau of Workers

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[5] This article was "the impetus behind Congress's focus on institutional investors." See Stephen J. Choi & Robert B. Thompson, *Symposium: Litigation Reform Since the PSLRA: A Ten-Year Retrospective*, 106 Colum. L. Rev. 1489, p. 1503 n. 90 (2006).

Compensation ("BWC")); *In re American International Group, Inc., Sec. Litig.*, Case No. 04-8141, filed Oct. 15, 2004 (S.D.N.Y.) (lead plaintiffs are OPERS, STRS Ohio, and Ohio Police & Fire Pension Fund ("OPFP")); *In re Global Crossing Ltd., Sec. Litig.*, Case No. 02 Civ 910, filed Jan. 28, 2003 (S.D.N.Y.) (lead plaintiffs are OPERS and STRS Ohio); *In re Marsh & McLennan Cos., Inc., Sec. Litig.*, MDL 1744, Case No. 1:04-cv-8144, filed Oct. 15, 2004 (S.D.N.Y.) (lead plaintiffs are OPERS and STRS Ohio); *In re Pilgrim Baxter Sec. Litig.*, (part of *In re Mutual Funds Investment Litig.*, MDL 1586), Case No. 04-md-01151, filed May 3, 2004 (D. Md.) (lead plaintiff is Ohio Public Employees Deferred Compensation Plan ("OPEDCP")); *Saunders v. Putnam American Government Income Fund* (part of *In re Mutual Funds Investment Litig.*, MDL 1586), Case No. 04-md-560, filed Mar. 5, 2004 (D.Md.) (lead plaintiff is Ohio Tuition Trust Authority ("OTTA")); *In re Scottish Re Group Ltd. Sec. Litig.*, Case No. 1:06cv5853, filed Aug. 2, 2006 (S.D.N.Y.) (lead plaintiff is STRS Ohio); *In re UnitedHealth Group, Inc. Shareholder Deriv. Litig.*, Case No. 0:06-cv-1216, filed Mar. 29, 2006 (D. Minn.) (OPERS and STRS of Ohio are co-lead plaintiffs).

Indeed, these state funds willingly litigate to protect their members' retirements, whereas the private funds do not. Private funds are discouraged from filing because it takes time and resources away from income-producing activities, may expose secret investment information, and results in a small benefit to the lead plaintiff. Choi & Thompson at 1504-05. Public funds, which do not have the same secrecy and income concerns, are more likely to bring fraud suits to protect state employee pensions. Additionally, public funds as lead plaintiffs protect the individual investor from fraud.

Thus, the state funds have become the primary check on securities fraud in the marketplace. Tellabs's proposed pleading standard will upset the incentive balance. State pension funds will be discouraged from filing legitimate

market-sanitizing lawsuits, and it will be much more likely that legitimate lawsuits will be dismissed even if they are filed.

B. The Court should reject Tellabs's pleading standard because Congress intended the SEC to protect private investors after having stripped them of some State remedies in this area.

The States traditionally have played a leading role in protecting citizens from fraudulent securities transactions. Indeed, the States preceded the federal government in regulating the securities industry by roughly twenty years, enacting the first comprehensive securities-fraud-prevention statutes as early as 1911. See Joseph C. Long, *Blue-sky Law Handbook: Developments in State Securities Regulation* § 1.01 (1985). These statutes were given the name "blue-sky laws" because they were reportedly "aimed at promoters who 'would sell building lots in the blue-sky in fee simple,'" 1 Louis Loss & Joel Seligman, *Securities Regulation* § 1-B-1 (3d ed. 1989) (quoting Thomas Mulvey, *Blue-sky Law*, 36 Can. L. Times 37 (1916)). As the country's first consumer protection laws, they were precipitated by "intermittent securities fraud waves" that swept across the U.S. securities industry in the first few decades of the twentieth century. See Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. Corp. L. 1, 18 (1983).

The federal government began to play a role in the area of investor and market protection only after the 1929 stock market crash. At first, the state and federal laws and regulators worked in tandem to protect both the market and investors from the adverse effects of fraud. Richard H. Walker, *Evaluating the Preemption Evidence: Have the Proponents Met Their Burden?*, 60 Contemp. Prob. 237 (Summer 1997). But in the 1990s, in response to a perceived increase in frivolous lawsuits, Congress made fraud suits harder to plead and litigate, and also preempted private class-

action applications of the state blue-sky laws. *Id.* With the passage of the PSLRA and SLUSA, Congress gave the SEC a significantly greater role in the protection of investors.

The States are alarmed by this case because Tellabs and the SEC are advocating a pleading standard so high that investors will be prevented from bringing most fraud suits. If that happens, the investor rights so carefully protected by the States for so many decades are in grave danger. And if investors are not protected from fraud, the market could return to the days when fraudulent promoters were the norm and not the exception.

In passing the PSLRA and SLUSA, Congress did not intend such a result, but intended instead a balance between discouraging frivolous suits and prevention of fraud. The States urge this Court to interpret the pleading standard in light of the balance Congress intended.

1. In response to rampant fraud in the securities industry, the States were first to protect citizen investors by passing "blue-sky" laws.cey

The securities industry in the early twentieth century engaged in a number of questionable practices. The 1900s and 1910s saw an unprecedented rise in sales of highly speculative securities to individuals with little prior experience in the stock market—usually farmers. Thomas Mulvey, *Blue-sky Law*, 36 Can. L. Times 37, 37 (1916). High-risk stocks were often sold by newspaper advertisements or mailing lists (deemed "sucker lists") that made extravagant claims about the virtues of the company selling the stock. See Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue-sky Laws*, 70 Tex. L. Rev. 347, 353-59 (December, 1991). Many farmers lost thousands in savings and mortgaged their farms on bad investments. See *id.* at 354 n.31.

A 1904 congressional report identified "secrecy and dishonesty in promotion," "secrecy of corporation administration," and "misleading or dishonest financial statements." See Seligman at 19 (quoting Report of the Comm'r of Corporations, H.R. Doc. No. 165, 58th Cong., 3d Sess. 30 (1904)). Corporate insiders also frequently engaged in stock "watering," or issuing stock in amounts far exceeding the value of the underlying assets. *Id.* (noting existence of at least 79 reported stock-watering cases between 1897 and 1910). See also *Old Dominion Mining and Smelting Company v. Lewisohn*, 210 U.S. 206, 210-11 (1908) (self-dealing in sale of mining property stock). *Id.* [6]

A second wave of securities fraud occurred in the 1920s, following World War I. 1-1 *Ohio Securities Law & Practice* § 1.02 (2005). Securities promoters obtained lists of Liberty Bond purchasers, who then became targets of predatory securities sales. *Id.* See also Gilbert E. Brach, *The Blue-sky Law*, 3 Marq. L. Rev. 142, 142 (1918-1919) (describing Liberty Bond purchasers as "easy prey, falling into the snare set by the wiles of the stock salesman"); Seligman, at 21 ("Beginning about the time of 1917 and 1918 Liberty Loan Sales campaigns, there was a noticeable increase in securities fraud, with many advertisements or salesmen successfully persuading purchasers of Liberty Bonds to exchange them for fraudulent securities.").

In response to these unscrupulous practices, the States passed laws to protect unsuspecting investors from fraud. Joseph C. Long, *Blue-sky Law Handbook* at 1-2. By first imposing registration and licensing requirements and later

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[6] A handful of contemporary academics have questioned the traditional account of the first wave of blue-sky laws as a response to market fraud. See Macey & Miller; Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J. Law & Econ. 229 (2003). However, the fraud-prevention explanation for the first wave of blue-sky laws continues to enjoy "nearly universal acceptance." See Macey & Miller at 349.

implementing additional antifraud provisions, the States sought to eliminate any securities that were not "fair, just, or equitable" to consumers. *Id.*

2. The federal government first regulated the securities industry only in the 1930s.

It was not until the stock market crash of 1929 and the ensuing depression that the federal government finally created a federal securities agency to deal with securities issues facing the nation at large. *Id.* Congress created the SEC, in the Securities Exchange Act of 1934, 15 U.S.C. § 78a, *et seq.* The SEC's mission was and is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." U.S. Securities Exchange Commission Website, www.sec.gov (February 27, 2007). Rather than displace state regulatory systems and state regulatory agencies that had been active for nearly two decades before the Exchange Act was passed, Congress specifically included a relatively broad savings clause preserving state-law rights and remedies. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 96 (1987) Scalia, J. concurring, quoting 15 U.S.C. § 78bb(a). Thus, from 1934 to the early 1990s, the SEC often worked hand in hand with state regulators and prosecutors to satisfy its charge.

In the 1990s, in response to a perceived increase of frivolous strike suits and industry calls for deregulation, Congress passed two new laws that shifted the balance of state and federal regulation. Harold S. Bloomenthal, 2 *Securities Law Handbook* § 25.4 (2007); Manning Gilbert Warren III, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60 Law & Contemp. Prob. 169 (Summer 1997); Erik Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 Conn. L. Rev. 393, 414 (Feb. 2006). The first law, PSLRA, was passed in 1995 and added a number of provisions to the

Exchange Act that make securities fraud claims more difficult to plead and litigate. 15 U.S.C. § 78u-4. The second law, SLUSA, was passed in 1998 and gave the federal courts exclusive jurisdiction over most fraud-based securities class actions. 15 U.S.C. § 78bb(f); see also *Manual for Complex Litigation* § 31.3 (2006). Before SLUSA, plaintiffs sought to avoid the more restrictive provisions of the PSLRA by basing their securities fraud complaints on less onerous state-law causes of action. Gerding at 414. Once SLUSA was enacted, however, state-law remedies and the state courts were no longer available for private class-action suits. *Id.*

3. The Court should preserve the balance created by Congress in the PSLRA and protect the interests of investing consumers.

"Any nation purporting to be governed by a rule of law must actually provide for mechanisms of enforcement against fraud and deception in its securities markets." Joseph Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough?*, 2003 Colum. Bus. L. Rev. 801, 809 (2003). Market discipline exits because "[c]orporate officers could be sure that if their pronouncements to investors were in any way misleading, they would end up on the wrong end of a lawsuit." *Id.* at 810-811. The private securities lawsuit has functioned as a "crucial component of the effective functioning of the securities fraud laws." *Id.*

The amici States are alarmed by this case because not just Tellabs but the SEC—charged with protecting the States' investing consumers—urges the Court to adopt a pleading standard that will effectively preclude most securities fraud suits. U.S. Brief at 15-29. SEC's standard would eliminate the "crucial component" of the checks against fraud and leave investors unprotected.

Indeed, the SEC until recently has argued for a much lower standard—the standard articulated in a well-developed jurisprudence by the Second Circuit.[7] The Second Circuit standard states that the requisite "strong inference" may arise where the complaint contains particularized facts that indicate that the defendants 1) benefited in a concrete way from the purported fraud; 2) engaged in deliberately illegal behavior; 3) knew facts or had access to information suggesting that their public statements were not accurate or 4) failed to check information they had a duty to monitor. See *Novak v. Kansas*, 216 F.3d 300, 311 (2d Cir. 2000). In other words, the Second Circuit used a flexible standard that does not require judges to make a finding of fact before discovery.

However, in its Brief before this Court, the SEC changes tack and now argues for an unreasonably high standard similar to the one that Tellabs asserts.

Industry scholars and advocacy groups are voicing legitimate concern for consumers and the future of securities law because of SEC's new position. See, e.g., Jonathan Peterson, *Critics Fear SEC Chief Is Seeking To Limit*

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[7] The SEC filed briefs in a number of cases advocating that the scienter pleading standard articulated by the Second Circuit was adopted by Congress in the PSLRA. Those available on Westlaw are as follows: *Caprin v. Simon Transp. Servs.*, No. 01-4049, 2001 WL 34664973 (10th Cir. July 2, 2001); *In re K-Tel Int'l., Inc. Sec. Litig.*, No. 00-3210, 2000 WL 35483737 (8th Cir. Nov. 15, 2000); *Helwig v. Vencor, Inc.*, No. 99-5153, 2000 WL 34432856 (6th Cir. Aug. 18, 2000); *Weld v. Stage Stores, Inc.* No. 00-20230, 2000 WL 34032458 (5th Cir. June 2000); *Lone Star Ladies Inv. Club v. Schlotzky's, Inc.*, No. 99-50958, 1999 WL 33620099 (5th Cir. Dec. 28, 1999); *Nathenson v. Zonagen Inc.*, No. 99-20449, 1999 WL 33613893 (5th Cir. Sept. 30, 1999); *Greebel v. FTP Software, Inc.*, No. 98-2194, 1999 WL 33911562 (1st Cir. May 1999); *Bryant v. Avado Brands, Inc.*, No. 98-9253, 1999 WL 33631523 (11th Cir. Feb. 16, 1999); *In re Silicon Graphics Sec. Litig.*, No. 97-16240, 1997 WL 33551249 (9th Cir. Nov. 1997); *Zeid v. Kimberley*, No. 97-16070, 1997 WL 33555504 (9th Cir. Oct. 1997).

Investors' Ability To Sue: Cox Says He Wants To Prevent "Abusive Litigation." But Recent Events Raise Questions About His Intentions, L.A. Times, February 20, 2007, at C1 (characterizing current SEC Chairman Christopher Cox as "the fox guarding the henhouse."); Stephen Labaton, *SEC Seeks To Curtail Investor Suits*, N.Y. Times, February 13, 2007 at C1 ("Critics said that the moves signaled a major retrenchment from the post-Enron changes and showed that a lobbying push by big companies, Wall Street firms and the accounting industry was gaining traction as they seek to roll back what they see as onerous regulation and excessive investor litigation."); Wall Street Journal Online, Law Blog *The SEC: Peeling Back Post-Enron Investor Protections?*, http://blogs.wsj.com/law/2007/02/13/the-sec-peeling-back-post-enron-investor-protections/ (February 13, 2007) (former SEC chief accountant Lynn Turner commenting, "This administration and this agency are very pro-business and anti-investor.").

While amici States agree that an important aspect of securities regulation is the prevention of abusive litigation, that side of the scale must be balanced by also encouraging legitimate securities-fraud suits. This is especially true when insider-trading and other frauds are still being uncovered. For example, thirteen individuals were arrested just this month as part of a large insider trading ring. Carrie Johnson, *13 Charged In Big Insider Trading Scam: Plots Touch 4 Elite Wall Street Firms*, Washington Post, March 2, 2007, at A01. A New York grand jury has indicted nine of the participants on conspiracy, fraud, and bribery charges, including brokers and lawyers from top-tier Wall Street firms UBS, Morgan Stanley, Bank of America Securities, and Bear Stearns. *Id.* If not kept in check by the potential for investor suits, insider trading and other fraud will increase.

Without private class-action securities-fraud suits, the States' citizens are in danger of a return to the days of rampant fraud and distrust of the market. When investors are

forced into federal court only to have *reasonable* inferences of recklessness or malice dismissed, the system is seriously unbalanced. The Court should preserve the balance by adopting the Seventh Circuit's standard.

Amici States strongly oppose the Tellabs-SEC pleading standard because it destroys the balance of the scales of justice, threatens legitimate securities-fraud claims, and potentially infringes investors' Seventh Amendment rights.

CONCLUSION

For the foregoing reasons, amici States ask that the Court restore the balance by affirming the Seventh Circuit decision.

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